



**MANUFACTURERS
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Economic Report

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Commentary
on Pertinent
Economic
Issues

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Business Conditions Update

Release of data covering the second quarter's gross national product, following such other developments as the drought in the farm belt and the earlier runup in prices of industrial raw materials, has shifted the markets' focus from fears of recession to fears of inflation. Although economic growth slowed a bit, the GNP deflator—which measures prices of goods actually purchased—rose at the fastest quarterly rate in four years. What is more, since monthly statistics suggest that the second quarter ended on a rising note, it is not improbable that the current quarter will reflect more growth—thus fanning more inflation fears.

Considering the age of the expansion, plus the fact that both the labor force and the capacity figures indicate that the economy is reasonably fully employed, you would think that the GNP results would be greeted positively by the financial markets. Not so: stocks, bonds and the dollar all fell.

What's going on? Are the markets sadists, or is this an Alice-in-Wonderland economy, where good news is bad news and vice-versa?

New Fears of Inflation

I think it has to do with latent concerns over inflation. Notwithstanding the fact that the annual rate of inflation has remained below four percent every year from 1982 through 1986 (a year that saw the 12-month increase in the consumer price index slow to only 1.1 percent—the slowest for any 12-month period in 21 years) and that 1987's rise in the CPI was only 4.4 percent, fears of inflation still affect Wall Street's thinking.

For one thing, the markets note that the Federal Reserve's Board of Governors consists of six people relatively inexperienced in central banking—all of whom were appointed by the same President. Considering that the Presidential election campaign is now getting into high gear, you can't blame the markets for worrying that the Fed might put political considerations ahead of eco-

nomic needs in managing the growth of money and the level of interest rates. The last time all Fed board members were chosen by the same President (thus, presumably, being all of the same political persuasion) was during the Administration of President Franklin D. Roosevelt.

Of course, most Fed members leave their political beliefs outside the door when they enter the central bank—but try telling the markets this, in view of the Fed's past performances during election years. Other than Paul Volcker's tightening of money shortly after President Carter appointed him in August 1979 (which ultimately set the stage for the mini-recession of 1980 and for Mr. Carter's loss to Ronald Reagan), the Fed has conducted monetary policy in such a way as to benefit the incumbent party. This is because it has traced a low profile by keeping money growth steady and interest rate changes moderate. True, this tends to be good for the economy—but what's good for the economy in an Election year, is usually good for the party in the White House.

If the economy were soft, the markets probably wouldn't begrudge the Fed a little easing. However, the economy does not seem soft; its growth of 3¼ percent in the first half of 1988 was a far cry from the recession that was widely expected in the wake of the stock market's crash last October. Reflecting this apparent strength (plus the decline in the foreign exchange value of the dollar against the major currencies between February 1985 and the end of last year) prices of most industrial raw materials have shot up. After hitting a low back in August 1986, the Commodity Research Bureau's Spot Price Index of 13 industrial commodities rose nearly 47 percent before tapering late in June.

On top of this, prices of foodstuffs have soared because of the drought in the Midwest. The CRB's Spot Price Index of 10 food commodities jumped about 22 percent earlier this year, and even after its recent decline stands at one of its highest levels in about three years. Compounding this is the

fact that capacity use in June was at its highest point in over eight years, while the jobless rate at midyear stood at a 14-year low.

Some Offsetting Factors

Are the markets justified in their concerns over inflation, or are there some mitigating factors that are being overlooked? I believe the latter is the case. For one thing, the price of one item that makes up at least two-thirds of business costs, labor, is still going up at a moderate pace. Although hourly earnings are rising at the fastest rate in about five years, because of advances in productivity, labor costs per unit of output rose only slightly faster in the past six months than they did in the previous half-year.

Then there is oil. Even before the cease fire between Iran and Iraq was announced, oil prices were heading lower. The benchmark West Texas Intermediate's spot price touched \$14.45 per bbl in the middle of last month, down from nearly \$17 several weeks earlier, and \$22.50 last summer. And this occurred after the North Sea fire which had the effect of removing some 500,000 b/d from the market. Although some believe that peace in the Middle East could boost oil prices, I would remind you that both Iran and Iraq are major oil producers whose needs for funds to rebuild their economies are obviously urgent. In order to obtain these funds, they will doubtless repair their oil producing facilities and begin pumping as much as possible. At their respective peaks in the mid-1970s, these two countries produced over eight million b/d—twice their recent combined output. Unless matched by output declines elsewhere, this will depress oil prices by at least several dollars a barrel—holding down inflation in the process.

As far as other commodities are concerned, prices of industrial raw materials appear to have topped out. Whether it is because of developing softness in the U.S. economy (table), or because of the dollar's rebound in the foreign exchange markets remains to be seen. The point is that, for the moment, anyway, price pressures from this source are clearly less intense. On the food front, the picture may not be so bleak, either. For one thing, rains have rescued some of the crops that had been threatened by the earlier dry spell. And those crops that have been reduced are either in good supply in the government's storage bins, and/or are available from other countries, whose growing seasons were not adversely impacted by the weather.

Keep in mind that prices of some food products are actually falling as a result of the drought. Ranchers have stepped up shipments of meat animals to markets, rather than be faced with significantly higher feedgrains' costs. Remember, also, the fact that farmers get only about 30 percent of the retail food dollar, so an increase of even 25 percent in prices received by farmers trans-

lates into a rise of only 7½ percent at retail—assuming that the various middlemen do not add a markup of their own. And foods represent only about one-fifth of consumers' budgets, so this would result in a one-time addition of only 1½ percentage points to the consumer price index, all-other things equal.

But all other things are not equal. The drop in oil prices referred to earlier pulled down energy prices in June—the first monthly decline since February. And clothing prices declined in June after flattening in May, suggesting resistance on the part of consumers to the earlier sharp runup. Indeed, price resistance still seems to be

MH FORECAST OF G (Seasonally Ad In

	1987			
	1	2	3	4
Gross National Product	4377.7	4445.1	4524.0	4607.7
GNP: \$82	3776.7	3823.0	3865.3	3923.0
% Change, Annual Rates	4.6	5.0	4.5	6.0
Consumption \$82	2490.2	2516.6	2545.2	2531.0
Durables \$82	378.3	391.3	406.5	381.0
Non-Durables \$82	889.9	889.8	891.9	890.0
Services \$82	1222.0	1235.5	1246.8	1253.0
Investment \$82	646.4	660.2	667.9	724.0
Non-Residential \$82	418.2	434.8	462.8	464.0
Producers Durable Equip. \$82	297.2	313.8	334.7	332.0
Structures \$82	121.0	120.9	128.0	132.0
Residential \$82	198.4	197.6	192.1	192.0
Inventory Changes \$82	29.8	27.8	13.0	67.0
Net Exports \$82	-132.8	-126.0	-130.7	-126.0
Exports \$82	394.9	416.4	440.9	459.0
Imports \$82	527.7	542.3	571.6	585.0
Government Purchases \$82	759.6	766.7	771.7	788.0
Federal Defense \$82	257.0	264.8	269.5	268.0
Federal Civilian \$82	77.0	67.3	72.6	79.0
State & Local \$82	438.9	440.1	440.8	444.0
Final Sales: \$82	3746.9	3795.2	3852.2	3855.0
% Change, Annual Rates	0.2	5.3	6.1	0.0
Domestic Demand: \$82	3909.5	3948.9	3996.0	4049.0
% Change, Annual Rates	3.4	4.1	4.9	5.0
Final Dom. Private Demand \$82	3120.1	3154.5	3211.2	3193.0
% Change, Annual Rates	0.6	4.5	7.4	-2.0
GNP Price Index (1982 = 100)	116.3	117.3	118.2	118.0
% Change, Annual Rates	3.5	3.5	3.1	2.0
Consumer Price Index (1967 = 100)	335.0	339.0	342.3	345.0
% Change, Annual Rates	5.3	4.9	3.9	3.0
Total Personal Income	3676.1	3736.1	3801.0	3906.0
Disposable Personal Income	3143.9	3154.1	3224.9	3315.0
Savings Rate	4.2	2.2	2.3	4.0
Unemployment Rate	6.6	6.2	6.0	5.0
Indus. Production (1977 = 100)	126.9	128.2	130.9	133.0
Housing Starts (000)	1778.7	1605.7	1618.7	1532.0
Domestic Auto Sales (000)	6684.3	7094.3	7977.3	6568.0
Dom. Auto & Lt. Truck Sales (000)	10120.3	10894.3	12064.1	10385.0
Corporate Pre-Tax Profits	261.8	273.7	289.4	281.0
Net Profits	135.5	141.1	149.5	145.0
Net Cash Flow	371.4	374.0	384.8	384.0

*Forecast

the order of the day. The price index that is part of the GNP accounts rose at an annual rate of less than three percent in the first six months of this year, compared with the CPI's 4½ percent jump. As previously pointed out, GNP-based indexes measure prices only of those goods consumed. They are shifting-weight, not fixed-weight indexes, like the CPI, or the Producer Price Index. The implication: People continue to shun those goods whose prices are rising rapidly in favor of those whose prices are going up more slowly, or not at all.

On another front, the inflation bears are worried that the economy is running out of room to grow. They

point to the jobless rate, which, as noted above, touched a 14-year low in June, and to the capacity utilization rate, which hit an eight-year high. In both cases, I would argue that there is still room to spare. The jobless rate, as you may recall, has been lower than June's 5.3 percent. In fact, it averaged 4½ percent from 1948 through 1973—a period that included five recessions, besides two wars. What is more, even though employment, both in numbers and as a percent of the non-institutional population over 16, was at a record at midyear, there remain more than 63,000 people who are over the age of 16 and not in institutions who could be available for work. If only 10 percent of these people were to decide simultaneously that they wanted work and none found a job right away, the jobless rate would nearly double.

Taking a look at capacity utilization, the eight-year high reported for June was lofty only in comparison with the past eight years. When compared with earlier periods, June's 83 percent rate of capacity use was not great at all. The ratio was nearly four points higher back in December 1978, and was over 90 percent on more than one occasion, back in the 1960s. At midyear 1988, by contrast, only two major industries' operating rates were higher than 90 percent, while only two others were above 88 percent. Most were in the low to mid-80s, and a few were actually running below 80 percent of capacity.

Interest Rates Should Stabilize

Nevertheless, as you may have gathered by now, my arguments neither determine market psychology, nor have much effect on interest rates, stock prices, etc. That being the case, I am cognizant of the fact that interest rates have risen in recent months, presumably because of inflation fears. The bellwether 30-year Treasury bond yield at the end of July was reaching for its highest level since the stock market crash, while Federal funds, representing short-term rates, have climbed by 1½ points from their February lows.

However, I don't think interest rates will move much higher—at least over the balance of this year. Long rates should stabilize as long as the actual inflation rate remains moderate. On the short end of the market, it is difficult to envision the Federal Reserve pushing rates up. For one thing, a Federal funds rate much above eight percent would encourage the banks to borrow from the cheaper discount window, where the rate is only six percent. This would negate the Fed's tight money policy. Of course, the Fed could boost the discount rate. However, the last time that happened, September 4, 1987, it was followed by the collapse in stock prices six weeks later. Election year considerations aside, then, a discount rate increase would appear to be a risky move, considering the state of the stock market and the uncertainties over the course of inflation and the economy.

Just, 1988 GROSS NATIONAL PRODUCT (Adjusted Annual Rates) Billions

		< Actual Projected >					
YEAR 1987		1988				YEAR 1988	
LEVEL	% CH	1	2	3	4	LEVEL	% CH
4488.5	6.0	4665.1	4712.7	4879.6	4934.0	4797.8	6.9
3847.0	3.4	3956.1	3986.3	4012.0	4025.6	3995.0	3.8
2520.9	2.7	2559.8	2574.2	2586.6	2596.5	2579.3	2.3
390.9	1.5	401.1	408.1	410.4	410.6	407.5	4.3
890.5	1.3	892.7	888.2	890.8	890.6	890.6	0.0
1239.5	4.1	1265.9	1278.0	1285.4	1295.4	1281.2	3.4
674.8	4.9	728.9	725.0	710.0	699.5	715.9	6.1
445.2	2.8	473.4	489.2	493.6	489.5	486.4	9.3
319.6	5.2	349.4	361.7	365.1	364.6	360.2	12.7
125.5	3.0	124.0	127.5	128.5	124.9	126.2	0.6
195.2	0.1	189.5	190.8	190.7	188.3	189.8	-2.8
34.4		66.0	45.0	25.7	21.7	39.6	
-128.9		-109.0	-90.1	-70.1	-65.2	-83.6	
427.8	13.1	486.2	495.6	509.7	514.9	501.6	17.2
556.7	7.9	595.1	585.7	579.8	580.2	585.2	5.1
771.7	2.6	766.0	776.1	785.4	794.9	780.6	0.4
264.9	5.3	264.6	260.9	259.9	259.8	261.3	-1.3
74.1	9.6	63.2	64.4	70.0	74.9	68.1	-8.1
441.2	3.3	448.7	451.9	455.4	460.2	454.0	2.9
3812.5	2.9	3890.1	3941.3	3986.3	4003.9	3955.4	3.7
2.9		3.6	5.4	4.6	1.8	3.7	
3975.9	3.0	4065.0	4076.4	4082.0	4090.9	4078.6	2.6
3.0		1.6	1.1	0.6	0.9	2.6	
3169.7	2.6	3233.1	3255.3	3270.9	3274.3	3258.4	2.8
2.6		5.1	2.8	1.9	0.4	2.8	
117.7	3.3	119.4	120.6	121.6	122.6	121.0	2.9
3.3		1.7	4.1	3.4	3.1	2.9	
340.4	3.7	348.3	352.4	355.6	358.7	353.7	3.9
3.7		3.4	4.8	3.7	3.5	3.9	
3780.0	7.0	3951.4	4017.2	4041.7	4098.8	4027.3	6.5
3209.7	6.3	3375.6	3416.5	3457.3	3502.9	3438.1	7.1
3.3		4.4	3.8	4.2	4.5	4.2	
6.2		5.7	5.4	5.6	5.9	5.7	
129.8	3.8	134.5	136.0	138.4	140.4	137.3	5.8
1633.9	9.8	1479.7	1474.0	1509.2	1508.8	1492.9	-8.6
7081.0	13.8	7640.0	7473.3	7310.3	7304.5	7432.0	5.0
10866.0	8.7	11778.8	11642.1	11352.1	11477.5	11562.6	6.4
276.7	17.1	286.2	254.3*	314.8	305.5	290.2	4.9
142.9	10.2	149.4	133.4	163.8	157.0	150.9	5.6
378.6	-2.0	387.9	361.8	391.3	383.8	381.2	0.7



Vitality

"Our plan is on track."

Shareholders' equity up \$776 million

Manufacturers Hanover Corporation reported earnings of \$403.1 million for the second quarter, or \$7.93 per common share, and major progress toward its goal of restoring common equity to four percent of assets. It also reported a \$250 million reduction in nonperforming assets during the quarter and lower operating expenses.

Highlights for the second quarter include:

- An increase in common shareholders' equity to 3.60 percent of total assets, up from 2.36 percent at June 30 last year. The addition of \$776.3 million in common equity over the past twelve months brings total common shareholders' equity to \$2.52 billion, up 45 percent from \$1.74 billion a year ago. At June 30, primary capital stood at 8.56 percent of assets and total capital was \$9.7 billion, or 13.40 percent of total assets.
- An increase in common shareholders' equity at Manufacturers Hanover Trust Company, the Corporation's flag-

ship bank, to 4.06 percent of assets, up from 2.80 percent a year ago. The Trust Company's primary capital at June 30 stood at 8.59 percent of assets.

- Net income of \$403.1 million, or \$7.93 per common share. These results include a gain of \$291.3 million (including tax benefits) from the sale of the Corporation's consumer finance subsidiary, Manufacturers Hanover Consumer Services, Inc., as part of its equity replenishment plan. For the first six months, net income was \$543.4 million, or \$10.52 per common share.
- A \$250 million reduction in nonperforming assets in the past three months and a \$521 million reduction in the past year. Nonperforming loans have been down for four consecutive quarters.
- Earnings of \$31.8 million at The CIT Group, more than double the \$13.9 million reported in the second quarter a year ago. For the first six months, earnings at CIT were \$62.0 million, up 61.8 percent from \$38.3 million last year.

Chairman and Chief Executive Officer John F. McGillicuddy said, "The addition of nearly \$800 million in common equity reflects success in our plan to largely restore common equity by the end of 1988 to four percent of assets—approximately the same level prior to last year's reserving action. Our overall results demonstrate that the key fundamentals of our financial plan—managing our business for higher returns, lower expenses and improving credit quality—are on track with expectations.

"Because our capital-raising actions since last June focused on common equity, they are consistent with the new regulatory requirements for risk-adjusted capital. We are confident that Manufacturers Hanover will be well within the requirements as they are phased in."

Mr. McGillicuddy added, "The results at CIT begin to underscore the potential of this organization. In addition to the efficiencies effected through the restructuring of CIT, charge-offs and operating expenses are substantially below last year's levels."



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